C WORLDWIDE
ASSET MANAGEMENT

Turbulence and Investment Principles

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When times get tough, it is essential to head back to the core –the core being sustainable long-term growth. That is the way to create attractive, long-term equity returns – compounding. Conversely, simple and short-term targets for equity value generally represent a risky shortcut.

Speculation vs. investment

Uncertainty is poison for the equity markets, and these days we are seeing a lot of uncertainty and market impact driven by coronavirus. The uncertainty is caused not only by the extent of this epidemic, but also by short- and long-term reaction patterns to the situation. We have no empirical data from a directly comparable event, but the outbreaks of SARS in 2003, of H1N1 in 2009 and other major diseases in the past 20 years had only short-term market impacts. At the present time, we do not know what the dynamic effects of this potentially global pandemic will be.

Financial markets are sending the dramatic signal that with interest rates and equity markets plunging the risk of a recession is back. Financial markets tend to have a short perspective that rarely extends beyond 12 months, especially during a crisis. A broad group of market participants is driving – whether consciously or unconsciously – this short-termism, this speculative approach. This is a very tempting discipline, yet rarely a profitable one. For most investors, frequently trading

in and out of the market is a losing strategy in the long term. The risk of selling only to miss the next upturn and loose the compounding effect long term is substantial.

At the present time, we don't know what the dynamic effects of this potentially global pandemic will be. Financial markets are signalling that the risk of a recession is back, with interest rates falling and equity markets weakening.

We discussed this issue in our Insight 'Global Equities - Buy, Sell or Hold?' from November 2018. Back then, we measured how much an investor in the US equity market would have gained by being continuously invested over the last 50 years (equal to approximately 10,000 trading days) compared with the return if he had not been invested on the best days in the market. The answer was that if you were not in the market on the 10 best trading days during the period, the massive positive return would have been cut in half and you would miss out on the entire return if you were not in the market on the 75 best trading days (which is less than 1 % of all trading days). The impact of missing out on the compounding effect is massive. Speculation is an uncertain discipline, and we would recommend taking an investment perspective instead.

How to identify sustainable growth?

The best investments are compounders that grow over time. We prefer sustainable long-term growth over the magnitude of growth. We spend most of our time working out "what companies to own" for the long term, and less on "what to pay for them". Our margin of safety when investing in a given company has to do with whether the company's long-term competitive advantages will stay strong and get stronger over the coming three to ten years. By focusing on the business model and the earnings potential over such a long horizon, we can improve the probability of identifying the winners of the future while also protecting the value of our investment over time. There is a herd of analysts following the world's largest companies and trying to find the 'correct' price, but most of them follow those companies on a short-term perspective. 35 research houses follow Visa, one of the world's largest companies, and give their 2020 earnings estimates through for example financial news and data providers like Bloomberg. The number of analysts drop to just a couple when it comes to 2022 or 2023 earnings. This difference illustrates the short-term orientation of the market. This creates opportunities for the strategic investor, and it creates an opportunity for C WorldWide's perspective and investment approach.

What about pricing?

High growth stocks naturally trade at a forward PE premium, creating a dilemma for classic value-conscious investors. Historical research shows that if high growth stocks deliver on their expected growth rates, their high PE multiples will drop to a more attractive level within a few years. This suggests that a high current PE valuation should not be a major concern as long as the company delivers on growth expectations.

Our first priority, therefore, is identifying the right companies and observe the long-term dynamics in and around the company. Valuation is a critical input in our decision-making process, but it is rarely if ever our starting point. In fact, valuation typically does not come in until all other aspects of a company have been analysed. We base our investment research on a dynamic analysis of the company's strategic position rather than focusing on a potential discount to its net asset value. Understanding the strength and longevity of the business model has much greater potential. We do this by focusing on opportunities and on identifying the winners of the future run by managements who understand that corporate responsibility and sustainable business models go hand in hand.

Many of our successful investments had a high PE multiple when we bought them. However, this is an optical illusion that underestimates the compounding effect of companies able to grow their earnings year

after year. One example is Alphabet (Google), which has regularly traded at high PE multiples. Nevertheless, this has been a high-return investment.

The magic of time

We believe that financial markets often underestimate the importance of time. The compounding effect is underestimated. However, growth only has value if a company has a competitive advantage that enables it to generate excess returns on its incremental investments – and the longer this period is sustainable, the better. The more attractive the investment opportunities available to a company, the better.

We believe that financial markets often underestimate the importance of time. It is the sustainability of growth, not the magnitude, that matters.

According to economic theory, competitive forces will ultimately eliminate a company's competitive advantage, but in practice we see a number of companies demonstrating the ability to maintain/extend their advantages over time. This applies particularly in today's digital society where networking effects strengthen the power of dominant companies. Albert Einstein is quoted as saying that the strongest power in the universe is compound interest. Earnings performance is a long-term driver of stock prices, and the Holy Grail of investing is to identify those compounders that over time can continue to surprise on the upside. We believe that a long-term focus on compounding is the best and least risky way to beat the market. This has been our approach for three decades, and we believe it is the right strategy going forward.

How to ride the waves of the current turbulence?

When short-term concerns dominate, it is important to stay true to your long-term investment strategy. In the current coronavirus situation, it is relevant of course to spend time to get to understand any lasting, long-term consequences that this tragic epidemic may have from an investment perspective. We will also consider whether certain stocks that are attractive for the long-term might be exposed to short-term selling pressure not relevant in a long-term perspective. We continually monitor and compare such potential investment candidates with companies already in our portfolio. Basically, we believe there are very few unique companies that qualify for a long-term investment. That is why over 30 years we have held on to the principle of having few stocks in our portfolio and to continually consider new candidates against the stocks we already hold. This is also our approach in the current situation – as it is in both good and not so good times – in order to consistently have the portfolio of stocks that is best able to deliver the best return/risk ratio and sustainable growth for the benefit of our clients.

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Our clients are primarily institutional investors and external distribution channels. Our product range includes discretionary asset management services and commingled fund products.

The combination of a unique investment philosophy based on careful stock picking and long-term global trends coupled with a stable team of experienced portfolio managers, has since 1986 resulted in world-class investment performance.

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